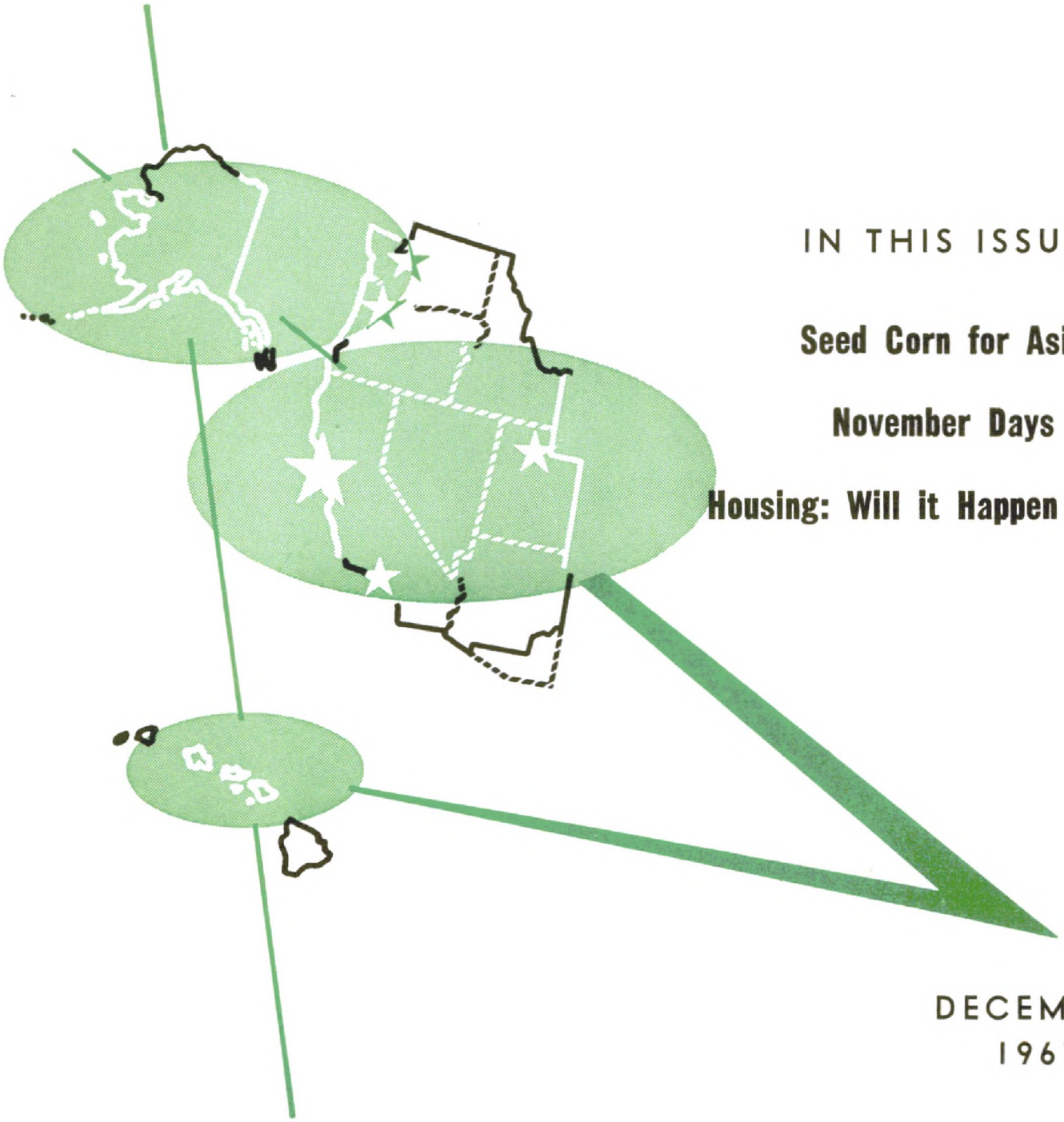
FEDERAL RESERVE BANK OF SAN FRANCISCO

MONTHLY REVIEW



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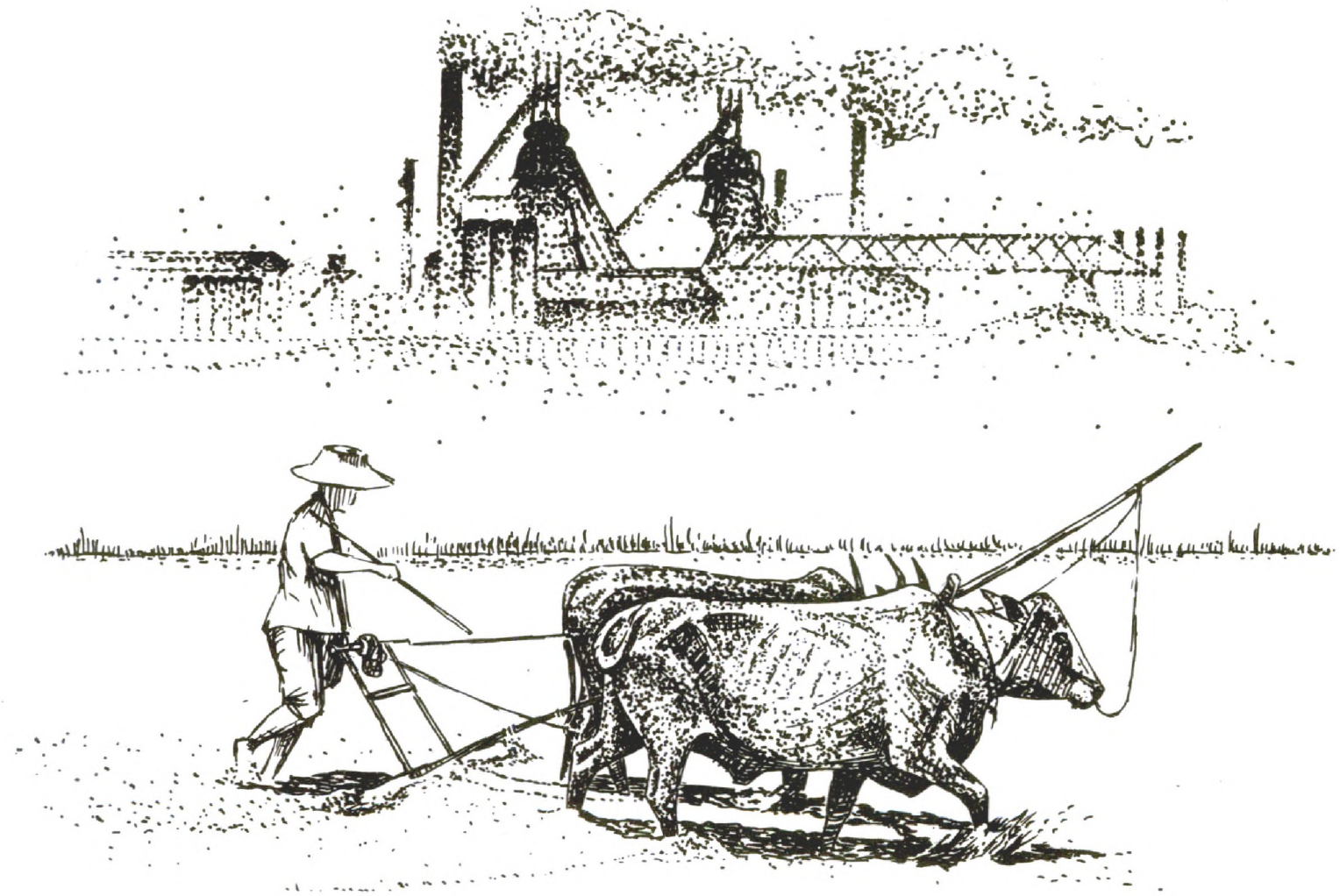
Seed Corn for Asia



THE Asian Development Bank (ADB) opened its doors for business in temporary quarters in Manila in December 1966. Some time may elapse before the Bank is able to carry on full-scale lending operations, but its appearance on the scene signifies the growing acceptance of the regional development-bank concept in the world of international finance.

The ADB is essentially an Asian institution, although any member of the UN or its specialized agencies can belong, and although its membership includes 12 non-regional members as well as 19 regional members. The original proposal for such an organization came from several Asian members of the Economic Commission for Asia and the Far East (ECAFE). Asian countries not only account for a majority of the membership but also control almost two-thirds of the authorized capital stock. The Asian members elect seven members of the ten-man board of directors, and this board in turn elects the president, who incidentally must be a citizen of one of the Asian member countries.

Regional banks—why?

The ADB's major purpose is to promote Asian development while adhering to sound banking practices. It is designed to act, in

the words of President Watanabe, "as a financial family doctor for Asia's billions."

The Bank's stated aims also include the promotion of regional co-operation and the stimulation of financial flows to Asia members. The Bank permits up to 10 percent of its paid-in capital (plus supplemental loans from members) to be used for soft loans or grants, and it permits up to 2 percent of its paid-in capital to be used for non-reimbursable technical assistance. (The 2-percent limitation will be dropped after the first five years of operation.)

The ADB is the third regional bank to be set up in recent years under international auspices, but it differs in some respects from the other two such banks, the Inter-American Development Bank (IADB) and the African Development Bank (AFDB). Developed industrial countries hold voting control in the Asian Bank but do not have a majority in the other two banks. This reflects the wide participation of industrial countries, both regional and non-regional, in the Asian Bank — whereas only one developed country (the United States) participates in the Inter-American Bank and none hold membership in the African Bank.

The Asian Bank has only one-half as much initial capital as the IADB but four times as much initial capital as the AFDB. The ADB plans to follow the IADB's example in floating bond issues backed by the Bank's callable capital, thus obtaining favorable terms in meeting its own financial needs. In the long run, at any rate, each of these regional development banks is designed to supplement its loanable funds by acting as a financial intermediary; that is, by borrowing in world capital markets and re-lending to regional borrowers.

But sufficiency of funds is not enough to assure the ADB that it can reach its goal of self-sustainable economic development of the huge area called Asia. To appreciate the problems facing the ADB, it might be well to look first at the nature of economic development itself.

Economic development — how?

Economic development is concerned with raising the average real productivity of a region's people. Many poorer countries suffer deficiency of resources or of knowledge

ASIAN DEVELOPMENT BANK—SUBSCRIBED CAPITAL AND VOTING RIGHTS

	Regional Members			Non-regional Members	
	Subscribed capital (millions)	Total votes		Subscribed capital (millions)	Total votes
Afghanistan	$ 4.78	1,256	Austria	$ 5.00	1,278
Australia	85.00	9,278	Belgium	5.00	1,278
Cambodia	3.50	1,128	Canada	25.00	3,278
Ceylon	8.52	1,630	Denmark	5.00	1,278
China (Taiwan)	16.00	2,378	Finland	5.00	1,278
India	93.00	10,078	Germany (West)	34.00	4,178
Indonesia	25.00	3,278	Italy	20.00	2,778
Japan	200.00	20,778	Netherlands	11.00	1,878
Korea (South)	30.00	3,778	Norway	5.00	1,278
Laos	0.42	820	Sweden	5.00	1,278
Malaysia	20.00	2,778	United Kingdom	30.00	3,778
Nepal	2.16	994	United States	200.00	20,778
New Zealand	22.56	3,034			
Pakistan	32.00	3,978	Subtotal	350.00	44,336
Philippines	35.00	4,278			
Singapore	5.00	1,278	Grand total	965.00	120,618
Thailand	20.00	2,778			
Vietnam (South)	12.00	1,978			
Western Samoa	0.06	784			
Subtotal	615.00	76,282			

Note: Each member receives 778 basic votes plus one vote for each $10,000 of subscribed capital. Only one-half of the subscribed capital must be paid-in, and only one-half of that amount must be in gold or convertible currency; moreover, all paid-in capital is payable in five equal annual instalments.

and initiative in working whatever resources they have. Sometimes this means that new technologies are required. In addition, if the traditional economies are themselves basically inefficient, more efficient methods must be introduced as well. Where mechanization and industrialization are needed, heavy financial investments are a prerequisite to success.

Investment of course requires saving, whether in the form of domestic saving or in the form of direct foreign investment or foreign grants and loans. Poor countries have great difficulty amassing sizable volumes of savings voluntarily in advance of industrialization, and alternative means must be relied upon.

Saving is essential for economic development, but saving by itself is insufficient to promote growth. Some of the output produced is not consumed when an economy is saving. But such saved output must be put in a form suitable for investment: if economic development is to take place, pencils produced but not consumed (that is, pencils saved) cannot magically be transformed into the power lathes that may be needed. In real life, transforming the agricultural surplus found in underdeveloped countries into working capital for investment projects is far from an easy task. Among other things, political and social stability are required for the efficient transformation of savings into productive investment.

Indeed, in the real world, economic development is best seen as a combination of social, cultural, political, and economic changes which in turn bring about further changes in the economy. In this complex world, it is difficult to isolate any single factor as the prime mover in the development process. Suffice it to say that development is accompanied not only by the formation of investment capital, but also by a heightened spirit of enterprise, improvements in production techniques, and improvements in the economic qualities and productive capacities of labor.

The Japanese Case

The Japanese case would suggest that there are really no shortcuts to economic modernization—only a possibility of speeding up the process of industrialization when the environment is favorable. It also suggests that certain prerequisites — strong national solidarity, administrative and financial stability, good work habits, a strong propensity to save, high literacy, capacities for sustained agricultural growth, entrepreneurial skills, and the like — may be necessary before any great economic modernization is possible. It may take considerable time before enough of these characteristics have been developed in some Asian countries to permit them to move ahead rapidly with industrialization. Clearly if our policies of economic aid in Asia are to be meaningful, they should be aimed not at quick results, as in postwar Europe, but at a process of development over many decades.

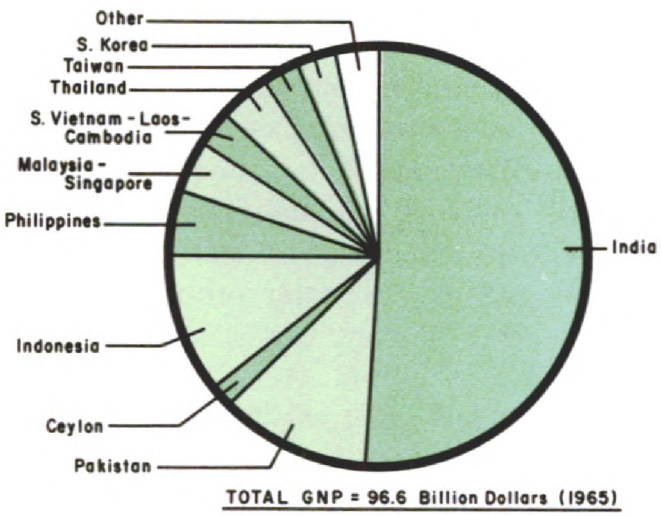
Edwin O. Reischauer
Beyond Vietnam: The U.S. and Asia

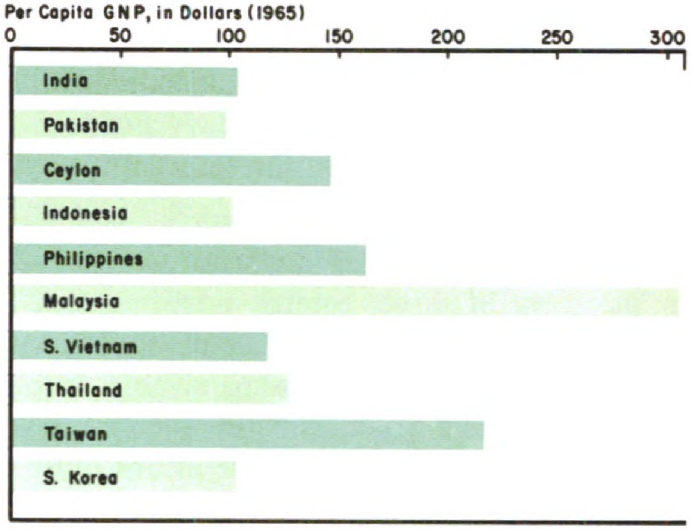
Development thus is seen as a process of change — technological, sociological, and economic change — where progress is constrained by a number of bottlenecks. These bottlenecks include shortages of human skills (for example, literacy), of advanced machinery, and of foreign exchange to import goods in short supply, along with a generalized lack of savings.

Finance — why and how?

The financial sector is deeply involved in each nation's drive to overcome the bottle-

Economies of underdeveloped Asian countries vary greatly in size, but almost all show a depressing sameness of per capita income





necks hampering development. When lending and borrowing opportunities are introduced into a modern money economy, both the efficiency of investment and the scope of entrepreneurial activity can be expanded. Larger projects can be organized and the best (highest yield) projects can receive the greatest supply of funds. Moreover, the great variety of instruments and institutions developed in a complex financial structure can increase both the amount of savings flowing into the market and the efficiency of the saving-investment transformation.

The diversity of instruments encourages the saver to save more, by confronting him with a wide range of yields, risk, and liquidity. The diversity of institutions also encourages savings by presenting the saver with competitive terms and conveniences. Such diversities also encourage entrepreneurs to borrow more; a wide range of loan contracts permits better terms on specific projects, and the provision of long-term funds for long-term projects circumvents the repeated transaction costs and future risks of short-term borrowing. The complex financial system which is taken for granted in the developed countries — but which is so woefully lacking in most underdeveloped countries — thus serves an essential role in smoothing the flow of funds from household savers to business investors.

Regional approach

The regional approach to development — the avowed aim of the regional development bank — is designed to stimulate a more efficient allocation of the world's limited resources in meeting its unlimited needs. This approach has several welcome features. Regional cooperation makes possible economies of scale through the expansion of trade, markets, and technological information. Regional cooperation, moreover, helps circumvent the regional boundary lines which cut across the unbroken seam of economic geography.

Disaster can result if this approach goes awry. Disillusion may breed distrust and stubbornness among nations, making develment more difficult than before. An overly broad plan may ignore special problems of participating nations, and thus stymie growth through conflicts of national self-interest. But

the existence of such difficulties only makes the basic task more urgent.

The ADB's approach is both a *regional* approach and an *Asian* approach. This is more difficult than it sounds, since Asian economies vary widely in their size, diversity, and scale of development. In fact, even their basic working methods differ; for example, Malaysia's development office is run energetically with Sandhurst efficiency, while Indonesia's program under the Sukarno regime concentrated on the preparation of a mammoth development plan — 8 books, 17 chapters, and 1950 pages, arranged so as to commemorate the founding date of the Republic (8-17-50).

Asia — how poor?

Despite certain statistical weaknesses, the available figures still paint a picture of an area containing a handful of prosperous and fast-growing economies (such as Japan and Australia), another handful of relatively poor yet growing economies (such as Taiwan and South Korea), but a much larger number of poor countries struggling to break free of their ancient chains of poverty.

The development experts, in concentrating their attention on the latter countries, see a group of nations which are plagued by underproduction of everything except people.

GNP estimates for 1965 show a wide range of income, from India with its $49 billion to

The Missouri and the Mekong

Americans know what can be done with natural resources. We know that a single river can transform the lives of millions. Properly developed, it can provide food, jobs, and transport. It can be an avenue to the bounty of modern life.

What has worked here will work in Asia.

Flowing through Thailand, Laos, Vietnam and Cambodia, the Mekong river drains an area 60% the size of the Missouri Basin. But only 8½ million people live in the Missouri Basin. Thirty million draw their sustenance from the lands surrounding the Mekong. The Mekong's flow is eight times greater than the Missouri's, and its hydroelectric potential is two to three times as great.

Ten solid years of work have already gone into careful and comprehensive planning for the Mekong area. The Mekong Coordinating Committee, along with 23 donor nations and 18 United Nations agencies, have:

—invested $30 million in the most detailed study of the area.

—invested $70 million in three major projects which set the stage for full development of the region.

—identified 34 potential tributary dam sites and completed detailed studies on 11 of them.

—conducted feasibility studies on 3 of the 12 potential mainstream dam sites.

These are examples of the sound ideas and projects which will be financed by the Special Funds I propose today. They are the Asian equivalents of the Erie Canal, the Transcontinental Railroad, and the land-grant college system which transformed our own society.

President's Message
September 26, 1967

Laos with only $200 million. On a per-capita basis, however, the figures show a depressing sameness of low income, ranging from $100 or less in India, Indonesia, and Pakistan to $300 and $500, respectively, in the relatively prosperous (or simply market-oriented) countries of Malaysia and Singapore.

The task of raising per capita growth rates is bedeviled by population growth; children, after all, are consumers and not producers. Population growth rates average 3 percent or more in such countries as South Vietnam, Thailand, Taiwan, and the Philippines, and although rates are lower — about 2 percent — in India, Indonesia, and Pakistan, the latter countries with their two-thirds of a billion people find their limited resources strained to the breaking point.

Where a large work force exists, the development of production is hampered by a basic lack of skills — three-fourths of the population of the Indian subcontinent is illiterate — and where the work force is so close to the subsistence level, it is hard pressed to set aside resources for capital formation. The ratio of capital formation to GNP, which ranges from 8 percent in South Vietnam to 20 percent in Malaysia and Thailand, nowhere approaches the level attained in such fast-growing nations as Israel, with its 30-percent figure.

These countries are underdeveloped too in their trade and other financial relations, not only with outside countries but also with each other. In 1965 only 7 percent of the production of the underdeveloped Asian nations was exported, and only 12 percent of that amount was traded among the regional countries themselves.

ADB and the breakthrough

The ADB's task is to support the economic breakthrough of this appallingly poor region. With the Bank's present limited resources, its best approach is to provide seed corn in the form of investment in basic industries, to channel technical assistance to various countries, and to serve as a forum for future planning. In the latter field, the ADB already is sponsoring a comprehensive study of Asian agriculture in order to identify specific projects needed to meet the food crisis of the next decade.

The Bank's direct lending ability is still limited. Its paid-in hard-currency capital stock is not much more than $100 million, and some time will elapse before it will be able to borrow on its own account or to assemble a sheaf of bankable projects. Moreover, in the words of President Watanabe, the ADB's first loans will be "sound" so that it can establish its own credit-worthiness for future borrowing. To supplement its efforts, the World Bank and the U.S. Export-Import Bank (among other agencies) can offer similar loans and loan guarantees.

Undoubtedly the major function of the ADB at this time is to provide technical assistance to underdeveloped Asian countries. Such assistance can be provided on a non-reimbursable basis, with spending limited to 2 percent of the Bank's paid-in capital stock for each of the next five years, and with no limitations on the amount thereafter. The assistance can take the form of project feasibility surveys, suggestions on project implementation, and *ex post* evaluations of project results.

The Bank's charter permits a certain amount of equity investment — a feature which should be a stimulus to young enterprises. For such firms, ADB participation (possibly with some repurchase option) may be the best means of acquiring working capital without the risk of bankruptcy or bond defaults in the first unprofitable years of operation.

ADB and the USA

The American interest in the expansion of the ADB was highlighted this September

COMPARISON OF REGIONAL DEVELOPMENT BANKS

	Inter-American	*African*	*Asian*
Start of business	October, 1960	November, 1964	December, 1966
Nonregional members	None	None	Twelve
Developed regional members	U.S.	None	Japan, Australia, New Zealand
Votes held by underdeveloped countries	57.5 percent	100 percent	35.4 percent
Capital structure (eventual)	$2,150 million authorized, of which $384 million paid in (Also $1121 million in Fund for Special Operations)	$250 million authorized, of which $125 million paid in	$1,100 million authorized, of which $550 million paid in
Debt outstanding (securities issued)	$449 million	none	none
Operations:			
1. Methods of operation	Direct investment; technological assistance	Direct investment; technological assistance; grants; investment in stocks	Direct loans; investment in stocks; technoligical assistance
2. Eligible institutions	Governments; government agencies; private enterprises; financial institutions for development	Governments; public enterprises; private enterprises; financial institutions for development	Governments; government agencies; political subdivisions; enterprises operating in the territory of any member; international or regional development groups
3. Maturity of loans	Ordinary capital, 8-20 yrs.; special funds, 10-30 yrs.; trust fund, 20-30 yrs.	Undetermined	Undetermined
4. Interest rates	Ordinary, 6½%; special funds, 4.00%; trust fund, 1.25-2.75%	6%	Undetermined
5. Limitations on Bank participation	Normally, less than 50 percent of project funds, also joint financing for large projects	Normally, less than 50 percent of project funds; for stock investment, less than 10 percent of the paid-in capital of an enterprise	Normally only the foreign-exchange costs of a project

when President Johnson proposed a $200-million, four-year contribution to new special funds designed to provide Asian countries with long-term, low-interest financing. The Administration proposed this type of contribution because of its interest in supporting the ADB's long-term financing capabilities, primarily through the provision of assistance for infra-structure projects.

In the President's words, "Where there are factories and power plants, there must also be dependable all-weather roads, farm equipment, and clean water supplies. The Bank must be able to lend for these long-term, as well as for short-term, necessities." Specifically, the Bank with this support should be able to move ahead in the fields of agriculture, river development, transportation, and communications.

The Administration made its $200-million pledge contingent upon other nations' pledging at least an equal amount in special-fund contributions, and upon the earmarking of U.S. funds for the purchase of U.S. goods and services for use in Asia. No cash disbursement is envisioned for fiscal 1968, and Congressional appropriations will be sought only as other nations pledge contributions to the fund. (Japan has already pledged $100 million, and Canada has also expressed a desire to contribute.)

As the ADB moves ahead on this and other fronts, it should become a very useful organization for promoting economic development in Asia. In the short run, it may play less of a role in lending than in providing technical assistance and support to demonstration projects. But in the long run, a generation hence, the Bank should be one of the most important intermediaries in channeling the flow of funds from the developed world to the less-developed countries of Asia.

—*Ronald Promboin*

November Days

The Pound Devalued . . .

The British Government devalued the pound on November 18 in a drastic attempt to cure the prolonged weakness in the nation's international position—a weakness which was accentuated this past summer and fall by the effects of war in the Middle East and industrial strife at home. In addition to lowering the value of the pound from $2.80 to $2.40, the Government raised Bank Rate (the Bank of England's fee on loans to financial institutions) from 6½ percent to a crisis level of 8 percent, and instituted a number of other deflationary measures designed to improve the U.K.'s competitive situation. . . . The British devaluation was quickly followed by similar action by more than twenty other nations that are closely tied to the sterling trade area. But the major industrial nations — the U.S. and the Common Market countries in particular—announced unequivocally that they would maintain the present value of their individual currencies. An intense speculative fever gripped European gold markets in the week following the British devaluation, but the fever died down after central bankers from seven of the major financial powers (not including France) met in Frankfurt and pledged all necessary resources to keep the price of gold unchanged at $35 an ounce.

. . . The American Response

In response to the British devaluation, the Federal Reserve Board of Governors approved actions by the Federal Reserve Bank of San Francisco and other regional Reserve Banks to raise their discount rates from 4 to 4½ percent, effective November 20. The System announced that it had moved in order "to assure the continued orderly functioning of U.S. financial markets and to maintain the availability of reserves to the banking system on terms and conditions that will foster sustainable economic growth at home and a sound international position for the dollar." . . . In the wake of the discount-rate increase, the 13-week Treasury bill rate jumped to 4.99 percent — up 34 basis points from the preceding week's auction rate of 4.65 percent. Moreover, large money-center banks posted increases in rates paid for funds, especially for negotiable certificates of deposit; the prevailing rate on CD's due in 90 days or longer quickly moved to the maximum permissible rate of 5½ percent. At the same time, these banks raised their prime rate on loans made to favored customers, from 5½ to 6 percent. The

higher rate had prevailed from August 1966 until last winter, when it was lowered in an attempt to stimulate domestic business activity.

. . . And the Balance of Payments

A further deterioration in the U.S. balance of payments in the third quarter, which implied a 1967 deficit higher than the '66 figure of $1.3 billion, provided the background to the announcement of the 1968 voluntary foreign-credit restraint program. The Federal Reserve asked commercial banks during 1968 to hold their foreign assets within 109 percent of the year-end 1964 amount — the same target ceiling that applied this year and last. But to prevent sudden surges of foreign lending, banks should use each quarter no more than 20 percent of their leeway under their individual targets, starting with the current quarter. . . . The Board also asked banks to use the end-October figure as the ceiling for non-export credits to the developed countries of Continental Western Europe, thus encouraging lending to finance exports and to benefit developing countries elsewhere. In addition, the Board set 1968 ceilings for nonbank financial institutions at 109 percent of their September 30, 1966 holdings (after specified adjustments), up from 105 percent this year. But the number expected to report regularly was reduced by limiting requests to those holding at least $500,000 in certain covered assets or $5 million in total foreign assets. . . . In the direct investment field, the Commerce Department asked corporations to limit their outflows for 1967-68 combined to 100 percent of the average annual amounts for the 1962-64 base period. Earlier ceilings were more liberal—135 percent of the base for the 1965-66 period and 120 percent of that average for 1966-67.

Housing: Will It Happen Again?

SUPPORTED by an increased availability of credit and an appreciable reduction in vacancy rates, the Western housing industry posted a fairly steady succession of monthly gains through October of this year. In the third quarter, housing starts in the West averaged 262,000 units (seasonally adjusted annual rate)—a 55-percent gain over last year's depressed third-quarter level and more than double the year-to-year gain recorded elsewhere. In October, starts were at an annual rate of 280,000 units—exactly double last year's October low.

Western housing starts are of course far below the unsustainable rate of 431,000 starts attained in 1963, at the crest of the last boom, and are therefore not endangering the construction outlook by such overbuilding as occurred that year. Indeed, despite the strength of the recent upturn, considerable ground remains to be covered before the rate of housing starts reaches the average level of the last building cycle.

The present outlook for the Western housing industry is clouded by developments in the credit markets, including a fairly sharp rise in interest rates and yields. Because of its potential impact upon the pattern of savings flows, the recent interest-rate trend has led to fears of a recurrence of the severe "crunch" which developed in the mortgage market in 1966. But a backward look at the golden days of the early '60's and the traumatic period of the mid-decade may suggest some answers to the question: "Will it happen again?"

Housing's boom . . .

From the beginning of 1961 to the mid-1963 peak, Western housing activity strongly outpaced the national industry with a 40-percent overall gain, until eventually the West accounted for over a quarter of total starts nationally. However, all of this District increase occurred in multiple units; permits for single-family structures remained virtually unchanged over the entire period. As a result, the District by 1963 accounted for about a third of the national total of new multiple starts.

Housing starts, especially of multiple units, increased faster in virtually every District state than in the rest of the nation. Within the District, however, the increase centered largely in the (six-county) Southern California area. On the strength of a 65-percent gain in total housing starts, Southern California's share of the District total jumped from less than a third in 1960 to one half in 1963. In fact, that region's share of multiple starts reached almost 60 percent in 1963.

. . . and housing's decline

The author of the dictum "What goes up must come down" must have been inspired by the post-1963 collapse of the Southern California housing market. For just as the area led in the strong expansion of the two preceding years, so it led what turned out to be the sharpest decline in housing activity in the history of the West.

Paced by an 84-percent reduction in new multiple units, total housing starts in Southern California registered a sustained decline of 75 percent from 1963 through 1966, and thereby accounted for three-fifths of the decline in the entire District. Southern California, moreover, accounted for a third of the net decline in housing starts nationally. Nevada and Arizona suffered even sharper percentage declines. On the other hand, Hawaii, Oregon and Washington, which had exhibited fairly steady but less spectacular gains in 1961-63, continued to grow during the downturn elsewhere.

But even these statistics fail to put the

Western housing slump in adequate perspective. For one thing, the decline in housing activity *outside* of the District did not begin until the end of 1965—a good two-and-a-half years later. In fact, housing starts in the rest of the nation continued to rise in both 1964 and 1965, and only declined last year, when the supply of mortgage credit tightened nationwide.

In 1966, when the heavy credit demands of businesses, consumers and governments assumed particularly formidable dimensions and pushed yields up to record levels, the flow of funds into mortgage-lending institutions dropped sharply, as did the outflow into mortgage loans. District member-bank real-estate loans rose by $244 million, only one-fourth of the 1963 volume, while the mortgage portfolios of District S&L's rose by $470 million, only one-tenth of the abnormal 1963 volume.

In the District, the reduced availability of mortgage credit contributed to a further decline in housing starts, and in the rest of the nation it contributed to the first decline in activity since the beginning of the decade. However, it seems fairly clear that the oversupply of housing created by the exceptionally strong boom in 1961-63, rather than the increased cost and reduced availability of credit, was responsible for the earlier and much sharper decline in the District.

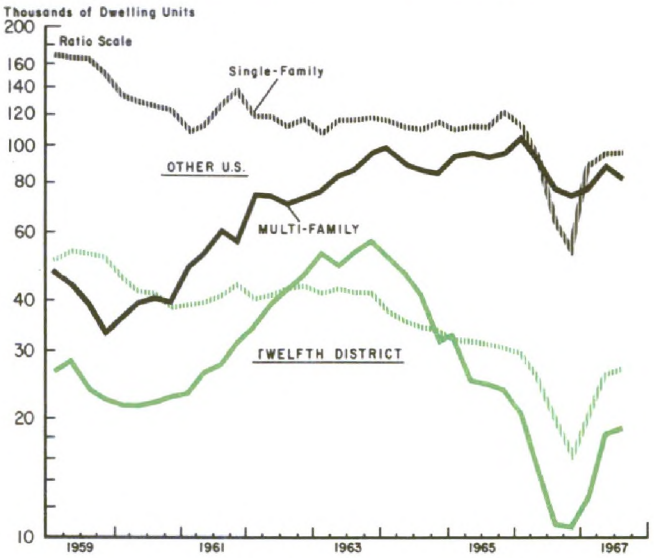
. . . related to basic demand factors

Financing, indeed, was not a major problem until the mortgage market tightened everywhere late in 1965. The rate of growth in both savings and real-estate loans at District banks and S&L's was still greater than in most preceding years, and the flow of funds was sufficient to keep the level of mortgage rates quite stable—lower, even, than during 1960-63. If anything, terms of lending (including appraisals and loan-to-price ratios) may have been excessively generous throughout the first part of the decade.

Easy financing and overbuilding eventually took their toll in the form of a sharp rise of mortgage delinquencies and foreclosures. The foreclosure rate of 1-4 family homes, as reported by mortgage bankers and commercial and mutual-savings banks in Western states, rose from about .20 percent in 1961 to .59 percent in 1966—a rate almost double that for the nation as a whole. And in 1966 the foreclosure rate for S&L's reached 1.48 percent in California, Nevada and Arizona—well over double the S&L rate nationally. In fact, District S&L's by the end of last year accounted for two-fifths of all S&L foreclosures in the entire nation.

During 1961-63, Western housing activity clearly outpaced basic demand as measured by net household formations. In Los Angeles County, for example, permits for new homes (including apartments) averaged about 100,000 annually over that period — substantially in excess of the rate of household formation, which had averaged about 64,000 annually in the 1950-60 decade and then dropped even lower, to roughly 56,000 annually, in the 1960-66 period. Even after allowance for demolitions, the increase in the housing supply far exceeded the incremental

Despite '67 recovery, housing activity remains below earlier peak



demand and thus contributed to a marked rise in vacancy rates.

These conditions were by no means unique to Southern California, however. Rising vacancy rates were evident in a number of areas throughout the District, including Salt Lake City, Phoenix, Las Vegas and the metropolitan centers of Northern California. By late 1965, in fact, the rental vacancy rate for the West as a whole reached 12.2 percent (seasonally adjusted), well above the national rate of 7.7 percent.

Housing's rebound . . .

Supported by an increased availability of credit, a rise in home sales, and a further reduction in the inventory of vacant units, housing starts in the West registered a succession of strong monthly gains this year, averaging a 262,000 unit annual rate in the third quarter. This was not only 55 percent above last year's depressed third-quarter level, but it also far outpaced the 25-percent year-to-year gain recorded elsewhere.

The recovery in the Western housing industry was somewhat stronger for multiple units than for single-family structures, although multiples still account for only about 40 per cent of total starts. During the third quarter of 1967, permits issued for the construction of multiple units were double last year's depressed third-quarter figure, in contrast to a 50-percent year-to-year gain in single-family units. (Outside of the District, multiples increased by about 45 percent over this period.) By mid-year, housing activity topped its year-ago level in every District state except Hawaii and Nevada.

. . . due to less surplus, more credit

In part, the strong recovery reflected a substantial reduction in the housing surplus, especially in Southern California. According to one recent survey involving 700 tracts in that area, the number of unsold homes at mid-year amounted to 27 percent of the total stock, down almost one-fifth from December and down by a third from June 1966. (In mid-1964 the unsold inventory had amounted to 42 percent of the units surveyed.) Apartment vacancies also have shown a sizable decline; the rental vacancy rate in the West declined from 11.4 to 7.8 percent between late 1966 and mid-1967 — a significantly greater reduction than the national decline from 7.0 to 6.3 percent.

The other major contributor to the housing recovery was, of course, the greatly enlarged flow of savings into mortgage-lending institutions. Aided by a combination of overall credit ease, a fairly sharp (albeit temporary) drop in yields on competitive instruments, and a high rate of personal saving, the flow of funds into District commercial banks and S&L's expanded sharply in the first half of the year, and the inflow continued at a healthy pace in succeeding months despite the increased attractiveness of yields available elsewhere. Time-and-savings deposits at District banks rose by over $2 billion (almost 9 percent) over the January-September period, while savings and certificate accounts at District S&L's rose by somewhat more, for a gain some six times greater than the total 1966 inflow.

On the other side of the ledger, real-estate loans at District banks increased by $312 million between March and September (after an early-year decline), and almost all of that gain took place in the summer quarter. Mortgage portfolios of District S&L's expanded by over $900 million through September—well over double last year's increase.

District S&L's have increased their mortgages less rapidly than other associations, however, partly because of their attempt to rebuild liquidity and to make repayments of previous heavy borrowings from the Fed-

eral Home Loan Bank. Since December, these repayments have amounted to $1.3 billion—40 percent of the total borrowings outstanding in the District at the time of the 1966 "crunch," and half of all repayments made by S&L's nationally. Moreover, they have lowered their ratio of loan portfolios to savings from a 1966 peak of 108 percent to less than 100 percent, the lowest level of the past several years.

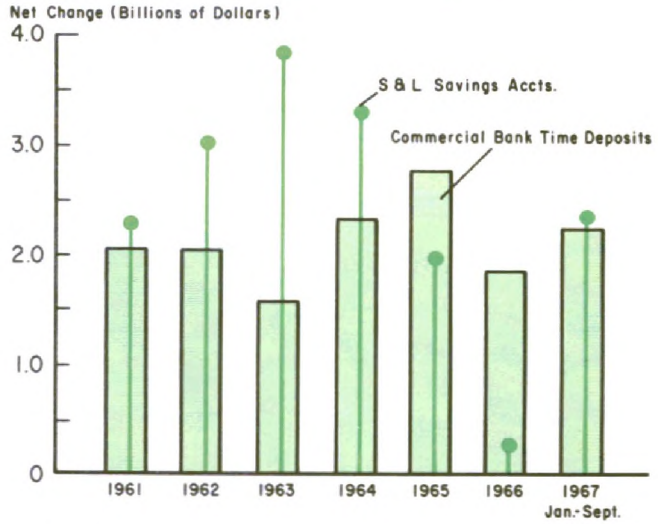
Disintermediation II?

In spite of the obvious improvement in the savings and mortgage picture, however, some signs of a possible slowdown appeared during the third quarter. For one thing, the flow of savings into Western S&L's moderated from its exceptionally vigorous early '67 pace, as gross inflows declined slightly and withdrawals increased appreciably. As a result, the withdrawal ratio at District associations—that is, withdrawals as a percentage of gross inflows—rose to 79 percent from a first-half figure of 71 percent, but it still remained well below the 96-percent ratio reached in last year's traumatic third quarter.

This trend reflects the conjunction of two factors—the recent rise in yields on competing market instruments, and the July 1 rollback in the maximum rate payable on S&L passbook accounts in the states of California, Nevada, Hawaii and Alaska. The rollback was from 5.25 percent to 5.00 percent, compounded daily to yield 5.13 percent. Elsewhere, S&L's generally are subject to a 4.75-percent ceiling, but they may pay up to 5.25 percent on certificates of only six-months' maturity, whereas S&L's in the aforementioned District states may pay this rate only on certificates of three-year's maturity.

Yields on competitive market instruments meanwhile have risen sharply. The three-month Treasury bill rate, after declining from 5.36 to 3.48 percent between last September

Housing rebounds as more savings flow into mortgage-lending institutions

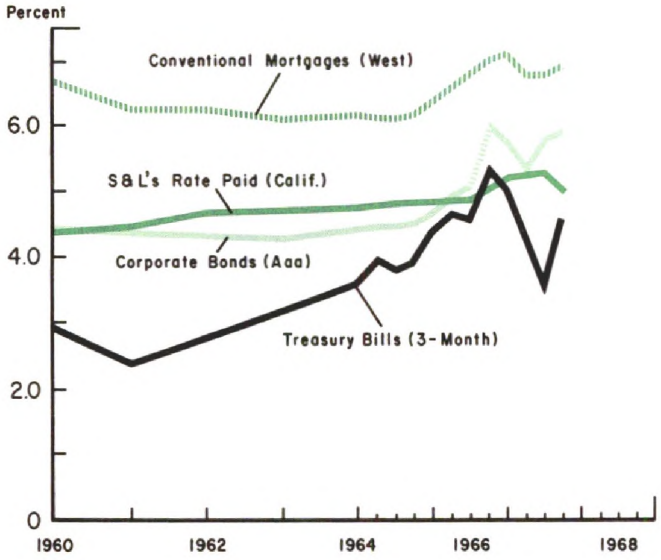


and this June, rose by about 96 basis points in the third quarter to 4.54 percent in September, while the yield on six-month finance paper rose by 50 basis points during the quarter to 5.00 percent. Following the devaluation of the British pound and the hike in the Federal Reserve discount rate in mid-November, the 90-day bill rate jumped further to just under 5 percent.

As a result of these changes, the yield spread between Western S&L passbook accounts and market instruments has narrowed considerably — in the case of the S&L rate and the 90-day bill rate, from 191 basis points in June to 59 basis points in September, and to only 14 basis points in late November. At the worst of last year's "crunch," the spread slightly favored bills.

The gradual slowdown in the savings inflow has been accompanied by a fairly sustained firming in mortgage yields and by a rise in discounts on government-insured mortgages. Consequently, yields on FHA 6-percent 30-year mortgages in the West rose by 42 basis points, to 6.65 percent, between early May and early November. (Government-backed mortgages account for 30 percent of District banks' real-estate loan portfolios, as against 18 percent elsewhere.) In

S&L's worry about rate rollback and rise in yields of other instruments



the same timespan, contract rates of interest on conventional (new home) mortgages rose by 20 basis points in the West, and by 15 basis points nationally, to 6.90 percent and 6.55 percent, respectively. In all cases, the changes brought mortgage yields to levels substantially above the lows of last spring and only slightly below the highs which prevailed in late 1966.

With the economy gaining steam, with heavy credit demands continuing from both the business and public sectors, with market yields rising and with tax-increase prospects still uncertain, the recent trends have created distinct uneasiness in the mortgage market. Federal Reserve Chairman Martin has warned that reliance by the Government on monetary restraint alone to cope with inflationary pressures might drive interest rates to "unprecedented levels," while FNMA Chairman Lapin has warned that efforts by the Treasury to cover its prospective huge deficit through borrowing in the market would make "the 1966 rate structure look like 'cheap money.' " Builders and mortgage lenders also have expressed their concern over the implications of rising interest rates for home-building.

Home costs rising

But another factor — the continuing upward pressure on construction costs and home prices — may also create problems in the future. Cost pressures pose a particularly difficult problem for the growing ranks of younger couples who, because of the high costs of home ownership, decide to move into apartments instead. In fact, this helps explain why multiple starts account for 40 percent of the Western housing market.

Rising costs also help explain the growing District market for mobile homes. Last year, for example, sales of mobile homes (which are not included in the housing-start figures) were almost one-fifth as large as total housing starts. In some District states, most notably Idaho, Alaska and Nevada, sales of mobile homes exceeded the construction of new homes.

Average hourly earnings of construction workers in California rose by over 16 percent during the 1960-63 boom, by an additional 16 percent during the 1963-66 slump—and by 6 percent more over the last year, reflecting what one trade journal called "the costliest labor contracts in history." The rise in construction wage rates has far outpaced the gains in other industry sectors, as well as the rise in the cost of living generally. Materials costs have risen less rapidly, by roughly 6 percent over the past four years, but land prices and taxes have soared.

As a result, the median price of a new home in the West has risen by a third in just the last four years—in spite of the conditions of oversupply which prevailed during most of the period—compared with a one-fifth increase in the rest of the nation. During the second quarter of 1967 alone, half of all the new homes built in Los Angeles county were in the $35,000-and-over bracket. The higher prices mean, of course, that financing requirements per unit increase proportionally—both for builder and buyer.

Continued gains?

Most observers have based their estimates for 1968 housing activity upon adoption of the Administration's 10-percent tax-surcharge proposal, although assessments of its likely impact upon housing vary considerably. Some commentators argue that the tax increase should reduce reliance upon monetary policy to cope with general inflationary pressures and thus should help check a further rise in interest rates generally and in mortgage rates in particular. Other observers argue, however, that would-be home buyers are more likely to be discouraged by a reduction in after-tax incomes, which would reduce their ability to meet down-payment requirements, than by an increase in the cost of money.

On balance, however, most observers envision an increase of about 10-15 percent in housing starts nationally, from an estimated 1.25 million units in 1967 to about 1.4 million units in 1968. For the West, a National Association of Home Builders study projects roughly a 15-percent gain to about 250,000 units. In fact, the national industry in the third quarter of 1967 already matched the rate of activity expected for 1968, and the regional industry exceeded the average '68 pace cited in the NAHB projections. Unless financing problems interfere, then, the housing industry should encounter little difficulty in meeting the production goals it has set for itself in 1968.

Over the longer-term, the industry foresees a sharp upsurge in basic demand nationally. In a recent study prepared for the Congressional Joint Economic Committee, the NAHB projected an annual demand for the 1966-70 period of 1.8-2.0 million housing units, and an annual demand for the 1971-75 period of 2.0-2.2 million units. (The 1961-65 average was 1.6 million units.) Translated into dollar volume, residential construction nationally by 1975 would be on the order of $66-73 billion, or more than double the 1965 volume. Clearly the demand is there, both in the West and in the rest of the country. The more interesting question in the light of recent history is whether the requirements for mortgage funds can be met.

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Western Digest

Shifts in Bank Credit

Total bank credit declined $450 million at major District banks in the first three weeks of November. Security holdings dropped by $412 million and loans declined $38 million — but loans exclusive of security loans *increased* $99 million. . . . Business loans showed greater than seasonal strength with a $156 million gain in this November period, reflecting in part the increased borrowing needed to meet the larger tax bite of California corporate-property and franchise taxes. In the durable-goods sector, increased borrowing of metals-and-machinery producers more than offset debt repayment by transportation-equipment manufacturers. In other sectors, large borrowings were posted by nondurable-goods manufacturers and trade firms.

Copper Strike Effects

Production losses in the five-month-long copper strike mounted to over 550,000 tons by the end of October, thereby reducing 1967 mine output one-third below the comparable 1966 level. But rising imports have permitted increased deliveries to fabricators without further depletion of already low domestic stocks. . . . The U.S. dealer price for refined copper remained at 64 cents a pound in November. But major copper fabricators, responding to earlier price increases in the dealer and exchange markets, raised prices on brass products in mid-November.

Rising Oil Production

District oil wells pumped over 1,150,000 barrels/day of crude petroleum in late November — about 15 percent above the year-ago level of production. On the basis of this rise in domestic output, District refining activity was able to increase in the face of a one-fourth decline in crude imports over recent weeks, to 260,000 b/d. . . . Western refiners hope to become completely free of their present dependence on foreign crude-oil sources within several years, because of rising output in California, Alaskan, and Arizona fields. But Alaska's increased output will not flow automatically to the domestic market; Japan, already an active bidder for Alaskan oil, hopes to obtain almost one-third of its growing requirements from that state by 1985.

Model Cities Program

The Department of Housing and Urban Development announced in mid-November that 63 areas (including 6 Western cities) would share in planning funds awarded under the model-cities program. The recipients include three California cities — Fresno, Oakland, and Richmond — plus Honolulu, Portland, and Seattle. . . . The awards were made on the basis of plans submitted by the cities for the rehabilitation of those neighborhoods characterized by a concentration of low-income families, substandard housing, high jobless rates, and deficient health and educational facilities.